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SPECIAL REPORT

Reform of the Taxation of U.S. Multinationals

INTRODUCTION

The Omnibus Budget Deficit Reconciliation Act of 1993 (OBRA), enacted this past August, increased the tax burden on U.S. multinationals as well as on foreign multinationals operating in the United States. Some experts conclude that OBRA's higher taxes will encourage U.S. multinationals to consider locating new plants and research facilities overseas rather than in the United States. Such an outcome has serious implications for U.S. job growth and living standards. Higher U.S. taxes on foreign multinationals could also have repercussions for U.S. companies operating abroad.

Recognizing the increasing importance of U.S. multinational corporations to U.S. economic strength and competitiveness, the ACCF Center for Policy Research commissioned Gary C. Hufbauer of the Institute for International Economics and Joanna M. Van Rooij of Erasmus University, Rotterdam, to examine key tax issues facing U.S. firms doing business abroad. This special report highlights their study, which Dr. Hufbauer presented at the Center's June forum, *Tax Policy for Economic Growth in the 1990s*. Also included are summaries of responses by panel members Charles J. Hahn, assistant tax director with Dow Chemical Company, and Deborah A. Lange, vice-president, taxation at Oracle Corporation.

U.S. MULTINATIONALS AND ECONOMIC GROWTH IN THE UNITED STATES

The United States is engaged in a long-term competitive game with Europe and Asia. In this context, the United States has two goals: to advance American prosperity as a leading industrial power and to promote an open international system. The U.S. taxation of international income should be reformed to further these goals, according to the study by Hufbauer and Van Rooij.

The modern theory of the multinational firm supplies the basis for reform. The starting point is the recognition that multinational firms engage in two distinct activities: (1) headquarters services and (2) traditional production and distribution activities.

Gary C. Hufbauer

The various headquarters services have special characteristics that help explain why companies become multinational: Most headquarters services can be used throughout the firm; headquarters services cannot be easily licensed to unrelated firms on a profitable basis; and many headquarters services can be efficiently produced only at a single location or in a very few locations.

The other major activities are the production and distribution of goods and services. These activities have their own special features: Although economies of scale characterize production and distribution activities, the economies are not so extensive as for headquarters services; production activities are highly sensitive to the cost and incentive conditions of different environments; rapid feedback from the market is critical for some production and distribution activities; and production establishments buy and sell components and business services among group members to achieve the lowest possible cost to the group as a whole and to supply members with unique goods and services.

The United States benefits twice when U.S. firms operate on an international basis. First, a U.S. multinational firm that has worldwide operations can far more easily spread its expensive overhead costs and thereby lower its average costs. Second, U.S. production abroad acts as a powerful draw on U.S. exports and U.S. export industries pay about 17 percent better wages than the U.S. average. Research indicates that the magnitude of U.S. direct for-

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eign investment in a given country is just as powerful a determinant of U.S. manufacturing exports to the importing country as the size of the country's total imports of manufactured goods from all sources. Unfortunately, rather than seeing the benefits of multinational operations, many policymakers have seemingly been captured by "runaway plant" fears. Foreign investment is thus viewed skeptically, if not as an outright assault on American prosperity. This view is totally at odds with the realities of the U.S. position in the global economy, according to Hufbauer and Van Rooij.

Reforming the Taxation of U.S. International Income

To advance American prosperity, U.S. tax policy should not be fashioned to curtail the global activities of U.S. multinationals. Instead, it should be designed to attract the headquarters activities of multinational firms and to encourage U.S. production and export of goods and services. Toward these ends, the authors recommend ten major changes for taxing U.S. multinational firms on their global activities.

- The United States should adopt a territorial approach to corporate taxation and renounce the taxation of dividend income received by U.S. parent firms from foreign affiliates that are engaged in active business pursuits abroad.

- The United States should repeal the foreign tax credit as it applies to business income.

- The Foreign Sales Corporation (FSC) exemption should be extended to cover U.S. exports of business services. Once the foreign tax credit is repealed, the exemption should be raised to 40 percent of export income.

- The United States should allow firms to allocate all headquarters expense incurred in the United States as a deduction against their U.S. source income. Importantly, headquarters expense includes research and development (R&D) expenditures.

Charles J. Hahn

- The United States should tax, at normal U.S. corporate rates, all royalties and fees paid from abroad for the use of expertise generated in the United States; and it should insist that royalties and fees are a proper business deduction in foreign tax jurisdictions.

- Correspondingly, the United States should allow a deduction for all royalties and fees paid by U.S. firms for the use of expertise generated outside the United States.

- The United States should ensure that all royalty and fee payments are exempt, on a reciprocal basis, from foreign and U.S. withholding taxes.

- In combination with the U.S. taxation of royalty and fee income from abroad, and the repeal of the foreign tax credit, the United States should enact an R&D tax credit of approximately 10 percent, applied to all R&D performed in the United States, not just to incremental R&D.

- The United States should emphasize the Advance Pricing Agreement (APA) mechanism, and it should set up an arbitration procedure for handling transfer pricing disputes.

- The United States should prohibit states from including foreign source income in their tax base via formula apportionment methods (such as the California unitary tax system) or otherwise.

Each of these changes should be considered not in isolation but as part of a larger package. No competitive benefit will come from picking and choosing just those parts of the package that promise to raise more revenue from U.S. multinational firms.

The authors conclude that it is a fallacy to imagine that international business can be taxed more heavily without economic consequences, or to see a contradiction between American prosperity and the worldwide operations of U.S. multinational firms. Instead, the Clinton administration and Congress should shape international taxation on the basis of guiding principles that promote U.S. national interests in today's era of global competition.

A CHEMICAL PRODUCER'S PERSPECTIVE

Making the case for reforming the taxation of U.S. multinationals, Charles J. Hahn, assistant tax director with Dow Chemical, noted that current policies make little sense because of the changes in the global economy. We clearly have the most complex international tax system in the world. In fact, Hahn suggested that the system is compliance proof, meaning no matter how hard we try to

comply, it cannot be done. The system is audit proof, meaning that no matter how hard the IRS tries to audit it, they cannot do it effectively, which leads to all sorts of problems including tax evasion. Complexity also leads to something else, he explained: When Dow has foreign business transactions, there are important U.S. tax consequences that flow from the U.S. system. The investment planners have to consult with the tax experts and by the time all is said and done, there are many projects that Dow cannot accomplish that the company ought to be able to do. The system has simply gotten too complex and that should be a major focus of reform.

In addition to being overly complex, U.S. tax policy towards multinationals puts U.S. firms at a competitive disadvantage vis-a-vis our foreign competitors. A National Chamber Foundation study concluded that compared to our major trading partners our competitive disadvantage ranges from 4 to 10 percent. Dow, for example, pays about 4 percent more in taxes than do its counterparts in the Netherlands.

Multinationals and Job Growth

Multinationals create very good jobs in the United States and they do so in two basic ways, according to Hahn. One is through what Hufbauer and Van Rooij refer to as headquarter activities—basically, the R&D performed in the United States—as well as the marketing and administrative work that creates the tangibles used inside the company. The broader the application of these headquarters activities, the more markets there are for them once they are developed and the greater the return, which in turn means more investment and jobs. And if you are a U.S. multinational, where are those jobs likely to go? They are likely to go where the company has its research facilities, or its critical mass, which, for Dow, is the United States.

As Hufbauer and Van Rooij said, the literature strongly suggests that those manufacturing operations increase, rather than decrease, exports. That has clearly been Dow's experience for several reasons. In the chemical industry, in general, the manufacturing facility must be located near the customer because of transportation costs, tariff and nontariff barriers, the need to provide technical services, and just-in-time delivery. If a chemical industry company wants to serve a customer in a particular market, it must have a local manufacturing presence or it cannot serve the local customers at all.

How does that impact U.S. exports? Dow's foreign manufacturing plant may manufacture ten products and may sell those ten products to its customers. But because Dow has that relationship, the technical service, and infrastructure Dow can also sell forty other products that it manufactures in the United States. In addition, the products this plant manufactures probably use raw materials from the United States. This strongly suggests that if a multinational succeeds in penetrating other markets, it will help to increase U.S. exports. Thus, a competitive U.S. multinational greatly helps the U.S. economy.

Deborah A. Lange

Conclusions

Unfortunately, under the present system, few tax advisors would suggest that a new company or one with a new, potentially profitable product, set up headquarters in the United States. Adopting Hufbauer and Van Rooij's proposals for reforming the tax treatment of U.S. multinationals would go a long way toward eliminating the competitive disadvantage U.S. companies face, Hahn concluded.

A SOFTWARE COMPANY'S PERSPECTIVE

Responding to the Hufbauer and Van Rooij study, Deborah Lange, vice-president, taxation for Oracle Corporation noted that the software industry is an excellent example of an industry where the United States is still the world leader. It is critical that such industries be allowed to maintain their leadership position and that the U.S. government does not, through penalizing tax law and other restrictive trade legislation, force companies to move jobs outside the United States or even restructure to be non-U.S. companies.

Oracle Corporation is the third largest software company in the world, Lange noted, developing and distributing relational database systems and related tools and applications. Its customers range from the U.S. government to the Fortune 1000 companies. It is headquartered in California but over 60 percent of its worldwide revenues come from outside the United States. Oracle does business in most international markets through a local subsidiary where it employs mostly local nationals. Oracle chose this structure for business reasons: its customers like to see a commitment to the local market, and a desire for a long-term relationship.

Oracle performs approximately 80 percent of its R&D in

California, the other 20 percent being developed in the Netherlands, the UK, and Ireland. To date, development has only been performed outside the United States when the development has been to meet local market requirements (such as translation or local accounting practices) or when it is necessary to work closely with a local hardware manufacturer.

Oracle Corporation, like all public companies, has a responsibility to its shareholders who seek a good return on their investment. Therefore, although Oracle would prefer to keep development in the United States and maximize the number of U.S. jobs, Oracle will make whatever business decisions are necessary to maximize the earnings per share of the company, for it is by that standard that a company's success is measured in the market place.

Tax Reform for U.S. Multinationals

The Hufbauer and Van Rooij tax reforms proposal would advance U.S. competitiveness, attract U.S. headquarter activities and encourage U.S. production and export of goods and services. Also these changes would result in simplification of U.S. tax law, which would allow us to focus on our business (we in the tax field would be the first to admit that we have enough other issues to grapple with), Lange stated. However, she noted that she did not believe that the United States will ever adopt these changes as a package. Realistically, it will always be a matter of picking and choosing in order to raise revenue.

A major issue needing redress is that services are, to a large degree, excluded from FSC benefits. The FSC and its predecessor, the DISC, were enacted to help U.S. exporters compete. The FSC is the only export trade incentive included in U.S. tax law and should apply to all exports. However, this is not the case.

For example, the FSC tax regulations allow a U.S. company to benefit from the FSC tax law if a master recording of a record or film is licensed and reproduced outside the United States. However, the regulation takes the position that the same treatment is not available for a master tape of software. Why should the entertainment industry be eligible for a tax benefit that is off-limits for the software industry, Lange queried.

The licensing of software by a U.S. company for reproduction outside the United States is the type of "true export transaction" that Congress intended to qualify as export property. Virtually all of the jobs (including vital R&D activities), capital investment, and training that developed the software are in the United States. The foreign licensing of master software disks allows the U.S. company to realize income reflecting all of the value added by the U.S. software development process. This allows the United States to maintain and develop its R&D efforts and keeps highly skilled jobs in the United States while generating export revenues. The denial of FSC benefits may encourage the movement of R&D activities overseas along with the related high-tech jobs of the future.

Exclusion of software from FSC benefits is a symptom of the failure of U.S. tax policy to move with the times. Because the software industry was not very large in 1984 and 1986 when the FSC rules were put in place it is excluded from the benefits. Tax law should strive for a more level playing field for all industries, new or old, Lange stated.

Consistent, Competitive Policy Needed

One of the greatest frustrations facing any U.S.-based multinational today is the changing face of U.S. tax policy. A prime example is the R&D credit, which is extended from year to year and about which there is no certainty.

Most foreign tax jurisdictions have developed a consistent tax position and they stick to it, Lange observed. Tax rates may change but, by-and-large, the general underlying concepts of taxation remain the same year-to-year and decade-to-decade. This enables companies in these countries to get on with their business, establish a structure that can remain in place for a reasonable length of time, and be relatively untouched by the excesses of tax audits, because the law is not constantly changing and wide open to interpretation. A U.S. multinational cannot be sure of U.S. tax policy for even the shortest period of time and thus cannot concentrate on establishing a workable business structure without the ever-changing face of U.S. tax policy getting in the way. The U.S. government should look to the other countries of the world that have established a workable tax system and stick with it. If U.S.-based companies continue to be hit with constantly changing policies, the actual impact may be quite detrimental; industry may move jobs outside the United States and the United States will lose U.S.-based global competitiveness. Foreign governments may also put into effect the reprisals that they currently threaten. With economic rivals such as the EC and Japan, the United States cannot risk the effect of poor tax policy, Lange concluded.

[1] The proposals and the underlying rationale draw on Gary C. Hufbauer and Joanna M. van Rooij, *U.S. Taxation of International Business Income: Blueprint for Reform* (Institute for International Economics: Washington, D.C., 1992), Chapters 4 and 7.